

GOVERNMENT POLICY AND FOREIGN DIRECT INVESTMENT INFLOWS IN NIGERIA: AN EMPIRICAL EXPOSITION

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ABSTRACT

This study sets out to examine empirically the role which government policy particularly in the areas of monetary, fiscal and exchange rate, in determining the inflows of foreign direct investment (FDI) in Nigeria (1980-2014). Data for the study were collected from secondary sources and analysed using multiple regression method, Johansen co-integrating technique and Error Correction Mechanism (ECM). The results revealed that there is a negative and significant relationship between foreign direct investment and the policy variables namely; inflation rate, foreign exchange rate, government fiscal deficit/surplus as well as the dummy variable (political risks factor). On the basis of the empirical results, it was concluded that government policy plays significant role in determining the inflow of foreign direct investment in Nigeria. The recommendations made include the following amongst others: the government has to allow the Central Bank of Nigeria to exercise its autonomy; ensure fiscal discipline, fight corruption sincerely, provide infrastructure in both rural and urban areas; reduce inflation, ensure security of lives and property of all and sundry.

KEYWORDS: Direct, Foreign, Investment, Inflow, Government, Policy

Received: Jul 05, 2016; **Accepted:** Aug 04, 2016; **Published:** Aug 06 2016; **Paper Id.:** IJECAUG20164

INTRODUCTION

The activities of every business enterprise both domestic and foreign are in some ways influenced by the policies of the government. Government policies may have direct effects on investment decisions of firms through legislations that regulate the conduct of business and their enforcements. However, a determination of the relationship between government and business enterprises will necessitate a consideration of the degree of respective responsibility taken by the government and business organizations in decisions involving the allocation of scarce resources.

Foreign Direct Investment (FDI) has remained a major concern of developing economies. The poverty situation of developing economies such as Nigeria and lack of sufficient capital to promote needed development necessitates appropriate policies focused on attracting and encouraging foreign direct investment. The enormous increase in foreign direct investment inflows across countries is one of the clearest signs of globalization of the World economy. The issues in attracting foreign direct investment are complex. Actions are required at different levels. Such actions need to be well calibrated in terms of policy instruments and well-articulated in strategic terms in order to turn the potential benefits of foreign direct investment inflows into tangible development outcomes.

External capital flows in form of foreign direct investment are non-debt-creating as opposed to debt-creating flows such as bank loans. Being non-debt-creating, foreign direct investments are preferred methods of

financing external current account deficits especially in developing countries where these deficits are large and sustained (Essien and Onwioduokit 1999). It is often argued that countries can only benefit from foreign direct investment inflows if they formulate and implement sound investment policies and put appropriate institutions in place. Poor policy framework particularly in the areas of institutional, monetary, fiscal and exchange rates could to a great extent inhibit the inflows of foreign direct investment (Samol and Solifano, 2014).

The need for foreign direct investment is particularly compelling in developing economies. Such economies generally require extensive enterprise restructuring because the extensive domestic resources base creates an environment for maximizing the potential benefits of foreign direct investment (Montiel 1993). Nigeria is well placed to benefit from foreign direct investment because it possesses a highly educated labour force in line with the arguments of Borensztien et al (1995). Nigeria being a mono-economy, highly dependent on oil resources and being vulnerable to external debt and economic shocks, the need for foreign direct investment cannot be over looked.

Evidence from literature has shown that foreign direct investment is a necessary factor for the growth and development of developing economies. In view of this, government policy becomes necessary to attract foreign investors. Policy makers in trying to attract foreign direct investment to the country often have exaggerated expectations of what their efforts can accomplish. Over the years, the government through series of policies had tried to influence foreign direct investment. Such policies include among others: reducing the overall fiscal deficits and macroeconomic stability. Others include, policies geared towards inflation reduction and ensuring realistic and stable exchange rates. Government believes that substantial implementation of these policies would be essential to laying the foundation for private sector-driven growth prospects and encourage the inflows of foreign direct investment, for economic growth sustainability (Jacques, 1999). It has also been argued that policy reforms in many African countries have been incomplete and thus have not fully convinced foreign investors to develop activities that are not dependent on natural resource availability and local market (Asiedu, 2005).

Therefore, in recognition of the role government policies play in attracting the much needed foreign direct investment in the country, the question thus arises: do government policies matter in attracting foreign direct investment in Nigeria? If yes, to what extent? If no why? What other factors affect foreign direct investment inflows in Nigeria other than policy factors? The answers to these questions will guide policy decisions and to test the potency of such policies in attracting foreign direct investment.

In line with this, the major objective of this paper is to evaluate the impact of government policies particularly monetary, fiscal and exchange rate policies on the inflows of foreign direct investment in Nigeria for the period of 1980 to 2014. On this basis, the paper is streamlined thus: section two is the review of empirical literature; research methodology and sources of data is the section three; section four is the various tests and results while section five is the summary of findings, recommendations and conclusion.

REVIEW OF EMPIRICAL LITERATURE

The government macroeconomic policy variables are found in the areas of policies. These policies determine the stability of the macro economy which is the bedrock for judging the efficiency of economic management. The macroeconomic policy indicators include among others, exchange rate, inflation rate, fiscal deficit/surplus etc. The prospects of price stability are conducive to foreign direct investment. Macroeconomic stability especially price

stability is certainly an essential ingredient in attracting foreign direct investment in an economy. Cagin fole (2012) studied the effect of price instability in macroeconomic performance with reference to foreign direct investment inflows. They found that price instability in the host economy constitutes major impediments to foreign direct investment in many Less Developed Countries (LDCs). Also Isam (2010) in a study of a political risk and foreign direct investment in Nigeria 1974-1986, found that menacing inflation in host economy is a major factor that discourages foreign investment in such economy.

Rogeff and Reinhart (2002) conclude that a high level of inflation in the host country impedes the inflows of foreign direct investment because such situation reflects macroeconomic instability and corruption, which erodes investors' confidence. Exchange rate movement would appear to be important factor investors take into account when making investment decisions. Yet one might argue that if exchange rate movements offset price movements so that purchasing power parity is maintained then there should be little effect on foreign direct investment flows. However, empirical evidence shows that purchasing power parity does not hold for all time periods and thus exchange rate movements are important in determining the flows of foreign direct investment.

Froot and Stein (1991), opined that the level of the exchange rate influences foreign direct investment because depreciation of the host country currency increases the relative wealth of foreigners thereby increasing the attractiveness of the host for foreign direct investment as firms are able to acquire assets relatively cheap. They use industry-level data on U.S. inward foreign direct investment for the 1970s and 1980s to support their hypothesis.

Using data for inward foreign direct investment to United State of America, in the wholesale industries in the 1980s, Goldbery and Kolstad (1995) found that exchange rate movement is an important factor affecting foreign direct investment inflows. They argued that investors are concerned with future expected profits and because of exchange rate instability, firms may temporarily postpone the decision to invest abroad as they would prefer to invest in a country where due to stable exchange rates their expected profits are less volatile.

In a study conducted using a sample of CFA sub-saharan African countries by Calvo and Reinhart (1999), they found that the incidence of high exchange rate instability is problematic because it cripples the foreign direct investment inflows. As a result, they are often an excellent barometer of broader and deeper problems in macroeconomic stabilization and governance. They maintained that the higher probability of exchange rate instability makes the African experience markedly different from the rest of the world. They argued that sustained exchange rate instability may be symptomatic of more general governance problems in many cases including corruption and creating obstacles to trade with deleterious consequences to foreign direct investment.

Olumuyiwa (2003), in a study of exchange rate uncertainty and foreign direct investment, in Nigeria, established a negative relationship between exchange rate and foreign direct investment. He observed that the exchange rate seems a more important driver of activities in the Nigeria economy. He opined that proper management of exchange rate, to forestall costly distortions, constitutes an important pillar in determining flows of foreign direct investment, in Nigeria and indeed sub-Saharan African countries. It is important that monetary authorities ensure transparency in exchange rate management such that various economic distortion associated with it are minimized.

Empirical studies have shown that government fiscal deficit/surplus is important determinant of foreign direct investment inflows (Samol and Solifano, (2014), Fernandez-Arias and Jim Kim (2010). Fiscal deficit is financed mainly

through borrowing. A high fiscal deficit is an indication of fiscal indiscipline and corruption which cripples foreign investors' confidence in such economy. Also high fiscal deficit financing through borrowing increases interest rates and reduces the availability of credit to the private sector.

Security of lives and property of foreign investors is an essential factor in attracting foreign direct investment. Without it, the risk of doing business rises. Political risk measures the risk of doing business in a country experiencing wars, riots, election violence, insurgency among others. The occurrence of these events impedes the inflows of foreign direct investment. According to Isam (2010), the primary concern of foreign investor is what he sees on ground. That is, the level of security, infrastructure and economic performance. In his study, he found that political instability, unstable economic performance, unstable exchange rate and menacing inflation are some great factors discouraging foreign investment. In his views, foreign direct investment would as a matter of fact be impeded in an economy experiencing high insecurity factors or where country risk" is high or where infrastructure is poor. He opined that Nigeria has been recording low inflows of foreign direct investment due to poor infrastructure, poor economic performance and threat of insecurity.

Other evidence in literature that recognizes political risk as foreign direct investment determinant includes those of Busse and Groizard (2006), Bolaky ad Freund (2004). In fact most countries in Asia, Europe and Latin America have achieved notable success in attracting foreign direct investment simply because of political stability, sound economic policy and security networks.

The study of Clark and Longman (2008) shows that foreign direct investment flows are greater to countries that have less political risk and better infrastructure. Contrary to expectation, they found that foreign direct investment flows are greater to countries with weaker currencies, smaller population and in industries where asset exploration is most likely such as privatization of telecommunications in the Nigeria case.

RESEARCH METHODOLOGY AND SOURCES OF DATA

In view of the fact that the data for this research were collected from secondary sources, the ex-post facto research design was employed. The methodology used involved the adoption of macroeconomic variables such as inflation rate, government fiscal deficit or surplus and exchange rate as policy variables as well as political risk as dummy variable.

Data on the above policy and dummy variables covering a period between 1980-2014 were obtained or collected from Central Bank of Nigeria statistical Bulletin (2014) and analysed using multiple regression, unit root test, co-integration, correlation analysis and error correction mechanism.

The dependent variable (FDI) in this study is measured as the net foreign direct investment inflows as a percentage of GDP. (Asiedu 2002, Quarzi, 2005, Goodspeed et al, 2006). The inflation rate here is used as proxy for monetary policy. It is used as a measure of overall macroeconomic stability (Asiedu 2002).

The exchange rate is used as the rate at which the naira is converted to foreign currency. Exchange rate is expected to affect foreign direct investment inflows because they affect firm's cash flows, expected probability and the attractiveness of domestic assets of foreign investors { Erdal and Tatogly (2002); Marian (1998)}.

The government overall fiscal deficit or surplus as a percentage of GDP is adopted as proxy for fiscal policy. Fiscal discipline is a measure of macroeconomic stability which exerts enormous influence on foreign direct investment decisions in the host economy (Samol and Solifano (2014); Fernandez-Arias and Jim Kim (2010)).

Political risk measures the risk of doing business in a country experiencing political instability, insecurity arising from insurgency, election violence, resource control agitations and so on. These factors could not be quantified, hence we use dummy variables assuming the value zero for non-occurrence of event and value one for the period of occurrence of event (Bolaky and Freund, 2004, Busse and Groizard, 2006)

Estimation Technique

The Ordinary Least Square (OLS) estimation technique was used to estimate parameters specified in the model. The correlation coefficient was used to measure the strength of linear relationship between the dependent and independent variables. The unit root test was employed to test the stationarity or non-stationarity in the data. By stationarity we mean that the mean and variance are constant overtime and the value of the covariance between the two time periods depends only on the distance or lag between the two time period and not the actual time at which the covariance is computed. The co-integration test was used to determine the long-run relationship among the variables in the model. This test as well as the unit root test was necessary to avoid spurious regression results.

Model Specification

The data used here was multivariate in nature. The model for the study is built to capture the variables as follows:

$$FDI = b_0 + b_1 IFR + b_2 FXR + b_3 GPDS + b_4 PR + U_f \quad (1)$$

Taking the logarithms of both sides of the equations, we have

$$\text{Log FDI} = b_0 + b_1 \log IFR + b_2 \log FXR + b_3 \log GPDS + b_4 \log PR + U_f \quad (2)$$

Where	FDI	=	foreign direct investment
	IFR	=	Inflation rate
	FXR	=	foreign exchange rate
	GDPS	=	Government fiscal deficit/surplus as % GDP
	PR	=	Political risk index (dummy)
	U_f	=	error term

$b_1, b_2, b_3,$ and $b_4 < 0$

DATA ANALYSIS AND DISCUSSION OF FINDINGS

The empirical results of the OLS regression estimated on the series data are as shown below:

Table 4.1: Level Series Multiple Regression Result

Dependent Variable: In FDI Method: Least Square Sample: 1980-2014 Included Observation: 35				
Variables	Coefficient	Std. Error	T-Stat	Prob.
C	-3.400564	2.10407	-1.56402	0.1004
InIFR	-0.421452	0.02451	2.34020	0.0165
In FXR	-0.340420	0.05246	5.10454	0.000
Table 4.1: Contd.,				
InGFDS	-0.142501	0.02124	1.30406	0.01425
InPR	-0.245104	0.020014	0.83402	0.00421
R-Squared	0.98704	Mean dep. Var.		10.2446

Adj-R-Squared	0.98520	S.D. dep. Variable		2.84640
S.E. of Reg.	0.46524	AKaike info. crit.		1.30404
Sum sq. resid.	6.15405	Schwarz crit.		1.50604
Log. Likelihood	-16.2940	Hannan-duinn crit.		1.361704
F- statistic	340.1742	Durbin Watson Stat.		1.18440
Prob (F-stat)	0.00000			

Source: E-view result

The results from table 4.1 indicate that the inflation rate was correctly signed and negatively related to federal direct investment inflows as well as being statistically significant. The government fiscal policy parameter met a priori expectation by being negatively signed and significant at 5 percent level. The foreign exchange rate was correctly signed (negatively related to FDI) and significant at 5 percent level. The continuous depreciation of naira against the US Dollar increase the relative wealth of foreigners thereby increasing the attractiveness of the host country for federal direct investment as firms were able to acquire assets relatively cheap. The political risk factor was correctly signed and statistically significant.

The R-squared and Adjusted R-squared value of 0.987 and 0.985 indicated that the independent variables explained about 99 percent variations in the dependent variable. The Durbin-Watson statistic of 1.19 is higher than the adjusted R-squared of 0.98520 and lies between 0 and 2 which suggests the presence of positive autocorrelation. Given the above, the results should be taken with caution since there may be some time dependence in the level series which could lead to estimation errors. Hence, there is the need to examine the stationarity properties of the level series data.

Test for Stationarity using Augmented Dickey Fuller Unit Root Test

Table 4.2: Unit Root Test Results

Variable	ADF Test Stat.	Order of Integration	Critical value	Sig. Level
In FDI	-8.42402	1(1)	-2.954	5%
In IFR	-6.40215	1(1)	-2.954	5%
In FR	-5.34004	1(1)	-2.954	5%
In GFDS	-4.84230	1(1)	-2.954	5%
In PR	-5.61420	1(1)	-2.954	5%

Source: E-view result

The results from table 4.2 indicated that all the variables are stationary at first difference. Also having established that all the variables are integrated of order 1(1), we employed the Johansen (1991) method for testing for co-integration among the variables.

Table 4.3: Johansen Co-Integration Test

Sample (Adjusted): 1982-2014 Included Observation: 33 after Adjustments Trend Assumption: Linear Deterministic Trend Series: In (FDI), In(IFR), In(FXR), In(GPDS), In PRLag Interval (in first difference): 1 to 1Unrestricted co-integration Rank Test (Trace)				
hypothesized no of CE(s)	Elgen Value	Trace Statistic	0.05 Critical Value	Prob.**
None	0.69804	72.404	69.814	0.0317
At most 1	0.41224	32.740	47.856	0.0704
At most 2	0.26704	15.1704	29.170	0.047
Table 4.3: Contd.,				
At most 3	0.15076	5.9017	15.546	0.0267
At most 4	0.016741	0.54671	3.7404	0.0416

Trace test indicates 1 co-integrating equation at 0.05 level
 * indicates rejection of the hyp.at 0.05 level
 ** mackinnon-Haug-Michelis (1999) P-values

Source: Author's computation

The result from table 4.3 indicated the existence of one co-integrating equation between the dependent and independent variables at the 5 percent level of significant. This therefore suggests that there is one long-run stationary steady state relationship between the dependent and independent variables within the sample period. It assumes a linear deterministic trend in the data and a lag interval of 1 of 1.

Error Correction Model (ECM)

In order to extend our analysis, the variables relationship is specified in an ECM, incorporating a one period lagged residual to examine the dynamic nature of the model. This is predicated on the robust ability of the ECM to restrict the long-run behavior of the variables to converge to their co-integrating relationship while allowing for short-term adjustment dynamics (Engle and Granger 1987).

Table 4.4: Parsimonious Error Correction Result

Dependent Variable: $\Delta(\ln(\text{FDI}))$ Method: Least Squares Date 04/03/2016: Time 1:20 Sample (Adjusted): 1984-2014 Included Observation: 31 after Adjustment				
Variables	Coefficient	Std. Error	T-Stat	Prob.
C	-0.14246	0.15241	-0.84002	0.4146
$\Delta(\ln(\text{FDI}(-1)))$	0.176701	0.01446	0.76114	0.04510
$\Delta(\ln(\text{FDI}(-2)))$	0.566714	0.566714	0.11246	0.00155
$\Delta(\ln(\text{FDI}(-3)))$	0.200144	0.12640	1.01240	0.3244
$\Delta(\ln(\text{IFR}))$	-0.114200	0.04640	0.76810	0.0442
$\Delta(\ln(\text{IFR}(-1)))$	-0.16720	0.02117	1.36407	0.00876
$\Delta(\ln(\text{IFR}(-2)))$	-0.00494	0.140074	0.03407	0.9614
$\Delta(\ln(\text{FXR}))$	-0.64540	0.24120	2.41670	0.0215
$\Delta(\ln(\text{FXR}(-1)))$	0.32404	0.02456	1.07760	0.2926
$\Delta(\ln(\text{FXR}(-2)))$	-0.37420	0.03461	-1.26476	0.0224
$\Delta(\ln(\text{GFDS}))$	-0.24034	0.05464	0.24640	0.06546
$\Delta(\ln(\text{PR}))$	-0.14306	0.01046	0.42056	0.05400
$\Delta(\ln(\text{PR}(-1)))$	-0.86446	0.36145	-2.76406	0.0134
$\Delta(\ln(\text{PR}(-2)))$	-0.57471	0.16740	-1.56224	0.1402
ECM (-1)	-1.00566	0.31446	-3.17046	0.0067
R-Squared	0.78224	Mean dep. Var. S.D. dep. Variable AKaike info. crit. Schuartz crit. Hannan-duinn crit. Durbin Watson Stat.		0.25664
Adj-R-Squared	0.58876			0.59446
S.E. of Reg.	0.36407			1.1976
Sum sq. resid.	2.26640			1.8640
Log. Likelihood	-3.56147			1.42114
F- statistic	4.07170			2.1450
Prob (F-stat)	0.004140			

Source: E-view result.

Results from table 4.4 indicated that the parsimonious error correction show a good fit with F-statistic of 4.07, and an adjusted R-squared of 58.9 percent, indicating that the independent variables jointly explained 58.9 percent of the total variations in the dependent variable. This represents a substantial reduction when compared to the level series OLS multiple regression.

The error correction term (ECM) lagged one-period with a co-efficient of (-1.00566) is also appropriately signed. The Durbin-Watson statistic at 2.14 shows absence of positive auto-correlation. The ECM coefficient of -1.00566 indicates

that dependent variable adjusts rapidly to changes, showing existence of long-run relationship between them.

The result of the parsimonious error correction model indicates a negative and significant relationship between inflation rate and foreign direct investment. The one period and two period lags of inflation rate are also negative and significant.

The results of the parsimonious error correction model also indicate a negative and significant relationship between exchange rate and foreign direct investment at 5 per cent level of significance. The one period lag of exchange rate showed a positive and significant relationship with foreign direct investment. However, the two period lag showed negative and significant relationship with foreign direct investment. (This confirms Erdaland Tatogh 2002).

The result also indicates that government fiscal deficit/surplus has negative and significant relationship with foreign direct investment. The political risk index factor showed negative relationship with foreign direct investment and statistically significant at 5 per cent level. Both the one period and two period lags of political risk (dummy) index were also negative and significant.

RECOMMENDATION

Based on our findings, the following recommendations are put forward. First, government recurrent expenditure should be reduced while increasing projects to reduce inflationary tendencies. This is because of the long-run relationship, between foreign direct investment and policy variables. Second, there should be appropriate or realistic exchange rate management policy to attract foreign investors. Third, the war against insurgency and corruption in the country should be intensified. This is in view of the negative significant relationship between political risk index and foreign direct investment. Besides, the autonomy of the Central Bank of Nigeria must be enforced. Government has to allow the Central Bank of Nigeria to perform duties in line with the economic circumstances.

Finally, given the importance of foreign direct investment inflows to the growth of Nigerian economy, fiscal discipline must be followed. Fiscal corruption must be checked because it portrays macro-economic imbalance and instability which drives away foreign investors.

CONCLUSIONS

From all indication, our results indicate that there exist a negative significant relationship between foreign direct investment (FDI) and policy variable proxied by inflation rate, exchange rate and fiscal deficit or surplus. The conclusion that is drawn from our results is that government policy is an important determinant of foreign direct investment in Nigeria. This implies that it is behooves on the government to reposition things, design appropriate policies to remove the bottlenecks militating against foreign direct investment in Nigeria.

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APPENDICES

Table 1

Year	PR	FDI	FXR	GPDS/GDP	IFR
1980	0	404.10	0.5464	-3.9	9.9
1981	0	334.70	0.6100	-7.7	20.9
1982	0	290.00	0.6729	-11.8	7.7
1983	0	264.30	0.7241	-5.9	23.3
1984	0	360.40	0.7649	-4.2	39.6
1985	0	434.10	0.8938	-4.2	5.5
1986	0	735.80	2.0260	-11.3	5.4
1987	0	2452.80	4.0179	-5.14	10.2
1988	0	1718.20	4.5367	-8.4	38.3
1989	0	13877.40	7.3916	-6.7	40.9
1990	0	4686.00	8.0378	-8.7	7.5
1991	0	6916.10	9.9095	-11.0	13.0
1992	0	14463.10	17.2984	-7.2	44.5
1993	1	29660.30	22.0511	-15.2	57.0
1994	1	22229.20	21.8861	-7.7	57.0
1995	0	75940.60	21.8861	-0.1	72.8
1996	0	111290.90	21.8861	-1.6	29.3
1997	0	110452.70	21.8861	-0.2	8.5
1998	0	80749.00	21.8861	-4.7	10.0
1999	0	92792.50	93.3917	-8.4	6.6
2000	1	115952.20	102.2408	-2.9	6.9
2001	1	132433.70	111.9958	-4.7	18.9
2002	1	225224.80	121.8892	-5.6	12.9
2003	1	258388.60	129.7642	-6.4	14.0
2004	1	248224.60	133.3267	-2.4	15.0
2005	1	654193.15	131.5892	-1.1	17.8
2006	1	624520.73	128.6008	-4.2	8.2
2007	1	759380.43	125.5150	-3.2	5.4
2008	1	971543.79	119.0533	-4.5	11.6
2009	1	1273815.79	148.8867	-1.7	12.4
2010	1	905730.77	150.2980	-5.4	13.7
2011	1	1360307.91	153.8616	-6.0	10.8
2012	1	1113510.00	157.5000	-4.2	12.0
2013	1	675100.00	155.9800	-3.6	8.0
2014	1	738200.00	169.6800	-1.7	8.0

Source: CBN Statistical Bulletin (Varwin Issues)